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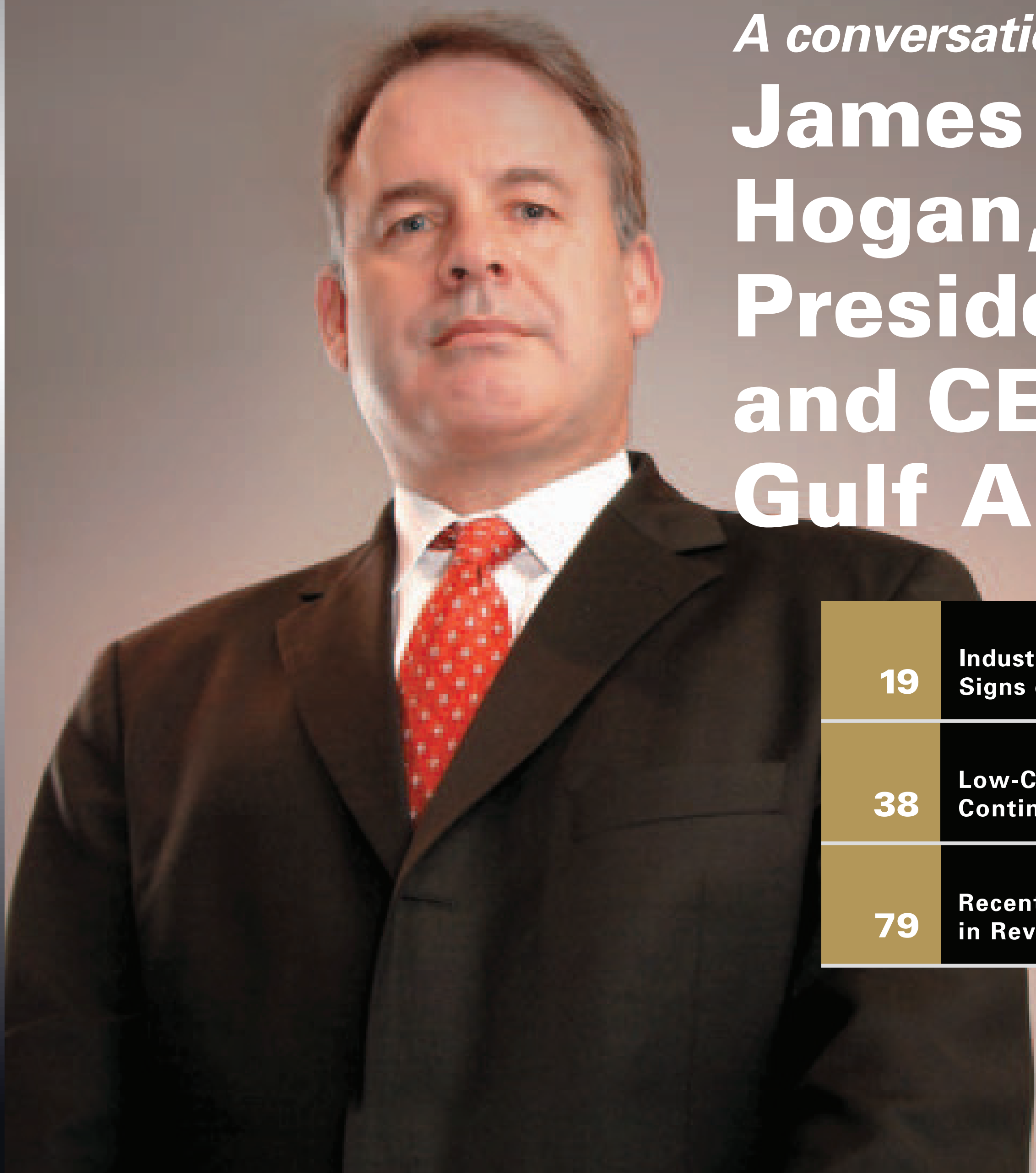
A conversation with …

James Hogan, President and CEO, Gulf Air



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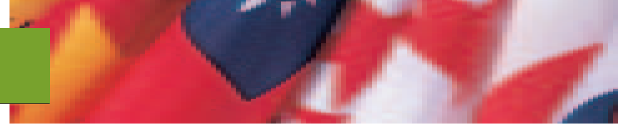


A Higher Plane

Facing unique circumstances, Middle East carriers are bucking global trends by adding service to satisfy customer demand and boost market share.

By Nejib Ben-Khedher and Shane Batt | *Ascend* Contributors

Ever since 1325 when Ibn Battuta, the renowned 14th century Arab adventurer, embarked on his famous 75,000-mile journey from Tangiers to India, the Middle East has had a rich history of international travel. That history continues today for a region at the crossroads between the east and the west.

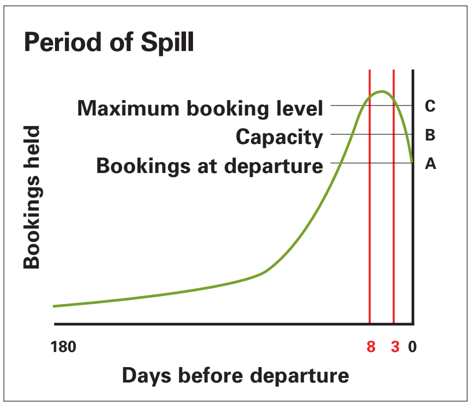
The area and its aviation industry are growing and continue to develop despite volatility caused by changing geopolitical conditions.

Although Middle Eastern airlines have been on a roller-coaster ride for the past three years, since January 2000 they have consistently out-performed the world average for traffic and capacity growth. Cumulatively, traffic growth in the region has averaged more than 12.5 percent since January 2000, surpassed only by the growth of traffic in Latin America (13.8 percent).

During the same period, capacity growth has been substantial. Middle Eastern carriers increased capacity by 11.3 percent since January 2000, primarily through fleet renewal and expansion. This capacity growth has been among the world's highest. Despite these encouraging numbers, there is a danger that carriers are increasing capacity too quickly and may have to allow it to become better aligned with demand.

In the first half of 2003, capacity to and from the Middle East was down by 6.5 percent while traffic was down 5.4 percent. Beginning in June, however, there was a rapid resurgence of demand, and the region's carriers reacted by significantly increasing the number of seats available. During August alone, passenger traffic grew more than 10.1 percent and capacity grew 6.1 percent year over year.

This growth has been concentrated primarily on intra-regional traffic. Traffic from Western Europe and North America has been substantially down since 2001, and flow traffic across the hubs of the region has also declined. During this period, however, economic and political circumstances have helped intra-regional traffic increase by more than 15 percent. The region's economies have grown rapidly based on increased oil revenues from higher crude oil prices, encouraging the region's residents to travel. (Paradoxically, this increase in oil prices has also raised the costs of air travel and lowered the profit expectations of Middle Eastern airlines.) From a political and social standpoint, citizens of the Middle East find it more convenient to visit other countries within the region compared to traveling to the West. A number of initiatives across the region have simplified visa procedures to attract local tourism. This intra-regional traffic growth is new for the area and is sparking increased investment in the regional airline industry.



Due to the booking patterns of most flights in which cancellations occur after the maximum booking level is reached, a market can be "constrained" by capacity even with load factors below 100 percent.

The downside to this high level of growth is that Middle Eastern airlines compete for market share using capacity — the most expensive method. When they increase capacity, market size increases through market stimulation, which is not sufficient to benefit all the carriers in the region. Instead, stronger airlines gain market share, and weaker carriers struggle. Since many of the weaker carriers are government owned, it is unlikely that they will disappear. Instead, they will become more desperate for cash and will cut fares to maintain market share, leading to revenue dilution and harder times for everyone.

The Middle East aviation marketplace is driven by four primary characteristics that are rapidly changing the airline environment:

- The introduction of new low-cost airlines,
- The impact of restrictive bilateral conditions,
- Highly volatile demand and extreme seasonality,
- The reemergence of high service levels.

The Allure of Low Cost

The low-cost model has become attractive for launching new airlines and for transforming national carriers in the Middle East. Governments wishing to increase tourism and stimulate economic growth are quick to invest in airlines claiming to be low cost. Investors allured by the promise of double-digit return on equity find investing in low-cost airlines attractive when the rest of the equity market shows only marginal returns. This phenomenon is especially true in the Arabian Gulf. The United Arab Emirates alone recently granted licenses to four start-up low-cost carriers.

Arabian Gulf investment in low-cost airlines is a new trend that has resulted from the increased economic prosperity of the region. Traditional Arab investment in the region has concentrated on service industries with much higher financial returns such as the banking and insurance sectors. Since the region's increased economic prosperity is oil-revenue based and subject to cyclical results, the equity currently available in the region for investment in airlines is somewhat tenuous. If this investment does not result in expected growth and income, then the prospects for future investment in the aviation sector within the Middle East will probably decline. In order to ensure success, the low-cost carriers in the region will have to generate high profits on a low cost base.

Low-cost carriers in the area will have to match the overhead of similar carriers in Europe and North America, where the stage length adjusted unit costs are between 2.1 and 3.5 U.S. cents per available seat kilometer. Maintaining costs at this level requires an airline to have a large number of seats over which to split the fixed and indirect costs. This means new low-cost airlines in the region must fly larger aircraft over shorter distances and turn the aircraft more times each day, increasing the glut of capacity and further diluting revenue.

Also, many characteristics of low-cost airlines are out of reach for new Middle East carriers because of their market and geographical position.

Commercial Characteristics

Whereas most low-cost carriers minimize distribution costs by relying on direct channels of distribution such as their own Web sites, Middle Eastern airlines rely on sales through the more expensive travel agency and tour operator channels. This is unlikely to change in the near future due to a relatively low penetration of the Internet, and any forced change on behalf of an airline would likely lead to reduced market share and the strengthening of competitors that rely on traditional distribution models.

Also in the traditional low-cost model, carriers operate high-frequency, shuttle-type operations between network points to capture maximum market demand. But in the Middle East, all but a handful of high-density routes are too small to accommodate such operations. Like other low-cost carriers, airlines in the Middle East can simplify pricing rules, but this will require a greater knowledge and utilization of available revenue management technologies. Another tenet of the low-cost model, exclusive point-to-point operations, would make Middle Eastern airlines vulnerable to competition and susceptible to the region's periodic political instability.

Operational Characteristics

Because low-cost carriers are primarily domestic — or at least operate in a common aviation environment under open skies — airlines in the Middle East would likely need to restrict their operations to specific geographical areas to eliminate international landing and navigation fees required for true international flights.

Fleet commonality, a characteristic of low-cost carriers because it maximizes utilization of equipment, personnel and maintenance resources, is possible, but it does not enable airlines to serve smaller markets or those requiring greater range.

To minimize costs, low-fare carriers generally offer limited service options. Because most passengers in the region expect higher levels of service than are provided on "no-frills" carriers, eliminating service options is liable to lower passenger satisfaction. And, due to limited demand and to the large amount of baggage on many flights, high frequency and short turn times would be difficult for Middle Eastern airlines to achieve.

Corporate Characteristics

A high equity base will ensure low-cost carriers' debt to equity ratio remains low. But many Middle Eastern airlines suffer from a low equity base, and there is little possibility, short of privatization, that these airlines can increase their equity bases to levels required to operate a low-cost airline. New entrants are remarkably well capitalized — at least during the planning stage — but actually producing the required equity for a startup may be more problematic than it appears.

While low-cost carriers maximize technology to reduce manpower needs, the effect in the Middle East would be limited because of the already low labor costs. Another way low-cost carriers control labor costs is through performance-based compensation for their employees, but this would have a limited effect in the Middle East without the implementation of the other low-cost carrier attributes.

Therefore, while attractive for existing and new entrants in the Middle East to consider the low-cost model, the realities of the region tend to discount it as a viable alternative.

But, airlines in the region do not need to be low cost in order to be successful. Due to existing bilateral conditions, airlines in the region have become accustomed to high yields and market exclusivity. As demand for air travel increases in the region, government authorities are becoming more liberal in granting licenses and routes. Governments want to increase tourism and diversify their economies by introducing new air travel capacity. This new-found largesse with air operator certificates and routes will allow new entrants into markets that are high yield. Therefore, new carriers will be able to pick and choose from the characteristics of low-cost airlines.

The Impact of Restrictive Bilateral Agreements

Despite substantial growth of the region's aviation sector, many markets remain underserved due to restrictive bilateral agreements and prohibitive taxation. In an effort to increase capacity, governments are investing in airport and airspace infrastructure. At the same time, however, they are increasing taxes and landing and navigation fees, and they are maintaining restrictive bilateral agreements designed to protect local markets for national carriers.

Market stimulation refers to increased traffic resulting from introducing capacity in an origin and destination market. The introduction of non-stop capacity tends to increase demand for air travel because the demand is constrained by available capacity.

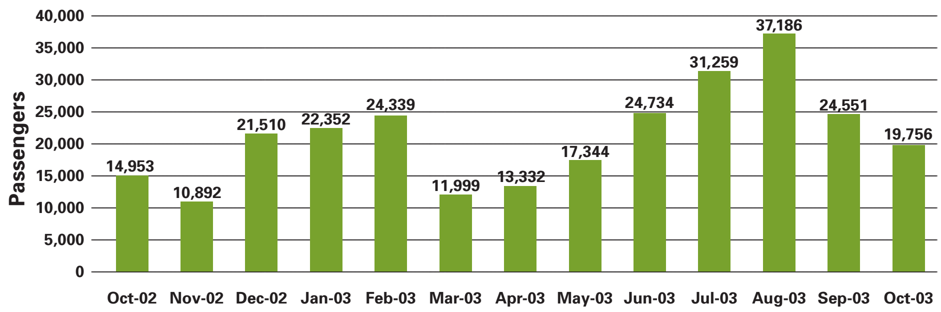
Governments wishing to protect local carriers with low load factors maintain restrictive bilateral conditions designed to keep capacity low, allowing yields to be high enough to support the operation of national carriers. National carriers argue that relaxing bilateral agreements will allow too much capacity to enter the marketplace, driving down yields. As yields decrease, the amount of government support necessary to maintain the national carriers increases.

Due to stimulation, however, restrictive bilateral conditions are more often liable to restrict the growth of the aviation sector instead of protect the local carrier. A good example is the rapid growth of Dubai as an O&D. Despite the growth of capacity in and out of Dubai, many O&Ds are substantially underserved.

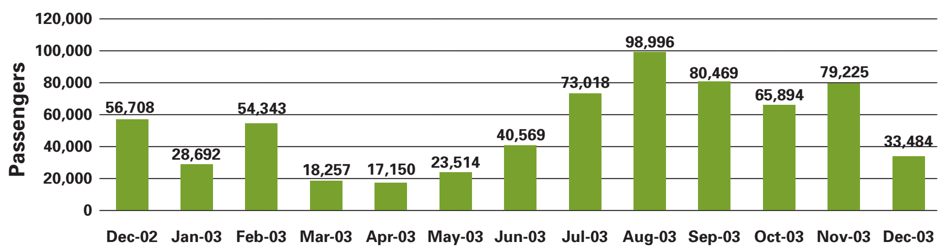
The growth of Dubai as a hub and as an O&D is a clear example to governments throughout the region. Spending more on infrastructure will not necessarily produce the "next Dubai." Governments that consider the relaxation of restrictive bilateral conditions can find an easy way to increase growth in the aviation sector without requiring significant outlays of capital to improve infrastructure.

The recently signed open skies agreement between Singapore and the United Arab Emirates (home of Dubai and Abu Dhabi, two

BEY — DXB Seasonality of Demand



CAI — JED Seasonality of Demand



As the Beirut to Dubai and Cairo to Jeddah markets demonstrate, demand in the Middle East region is highly seasonal and is influenced by several occasions such as religious holidays, Ramadan, the Hajj and similar events. Even secular events such as the Dubai shopping festival are driving substantial changes in demand.

regional hubs) is a model for improved bilateral conditions. Still, this relaxation is not enough. The recent position of the European Union with regard to bilateral negotiations should be a caution to the region. Under European Union regulations, bilateral agreements with third-party countries will be centralized in Brussels on behalf of all member states. Therefore, a small country such as Bahrain may negotiate and obtain rights to a few European destinations while every airline in Europe would obtain reciprocal rights in Bahrain. Undoubtedly, the Middle East region would be better served by an open skies agreement among its regional member states and a similar policy of collective bargaining between the Middle East region as a whole and larger blocs such as the European Union and the North America free trade zone.

Demand Volatility and Seasonality

Passenger demand in the region is highly volatile due to highly variable seasonality. While demand is high on an average basis compared to capacity, it is clumped into periods, making the application of capacity more difficult and creating a classic dilemma:

- For a carrier to win sufficient market share, it must have a consistent capacity presence and schedule regularity.
- Because demand is so variable, however, consistent capacity will sometimes be too little or too much.
- In order to address this, airlines must commit a smaller amount of capacity when demand is low and a larger amount of capacity when demand is high.
- This variable capacity violates the first requirement for winning sufficient market share.

Part of the reason for demand volatility in the region is easy to understand given the range of political events in the past four to five years. Each security alert, military action or bit of political tension affects demand.

A second reason for demand volatility is seasonal, but not just related to the 12-month Gregorian calendar. The lunar Muslim calendar shifts about 11 days each year. Specific events that greatly impact demand — religious holidays, Ramadan, the Hajj — result in profound changes in market demand. Increasingly, secular events such as the Dubai shopping festival drive substantial changes in demand. The 13-month seasonality of the Beirut to Dubai market clearly illustrates this volatility.

The demand in August 2003 was more than three times greater than the demand in November 2002. Also, the March through May 2003 figures reflect the Iraq war's affect on market demand. During the lowest month

THE HIGH • LEVEL view

News Briefs from Around the Globe

Who

British Airways, Virgin Atlantic, Ryanair and easyJet

What

Added their seats to the GetThere online corporate travel reservations system

Why

British Airways — "This innovative program helps us significantly lower our distribution costs, while ensuring that *Sabre Connected*℠ travel agents automatically have access to the full range of British Airways fares," said Dale Moss, director of sales worldwide at British Airways. "By making all our published fares available through the *Sabre*® global distribution system, we are making agents as competitive as any of our other sales and distribution channels."

(November 2002), demand per day in the O&D market was 363 passengers, about two round trips of a single-aisle aircraft. In August 2003, the demand per day was 1,200 passengers, about five round trips of a single-aisle aircraft.

Beirut to Dubai is not the only market in the Middle East that demonstrates this volatility. The extremely volatile seasonality between Jeddah, Saudi Arabia and Cairo, Egypt, also makes it difficult to plan capacity. During August 2003, the demand was more than five times greater than the low month of April 2003, a month with no Islamic holidays that coincided with security concerns in Saudi Arabia during the height of the Iraq war.

This demand volatility is not likely to significantly change. Carriers that best accommodate the variability of demand will earn the highest profits. Accommodating this demand can involve increasing capacity or reducing discount seat availability.

With such highly seasonal demand, it is somewhat inevitable that yields will be highly seasonal as well. During periods of low demand, prices will fall and during periods of high demand, prices will rise. Because the volatility of demand in the Middle East is so high, it becomes important for carriers to protect their yields during times of low demand to avoid a huge increase in the effective price of travel during the high season. Since Middle East carriers need to maintain the highest annual yields as possible, they must have higher yields during the low season to allow lower yields during the high season. The challenge becomes keeping yields higher during the low season.

The Reemergence of Service

As carriers in the Middle East struggle to maintain yields during the low season, they are increasingly trying to attract premium passengers. Premium passengers, including business travelers, tend to have lower seasonality than non-premium passengers. Therefore, several carriers in the region are experimenting with increasing service levels to attract and maintain higher-yield passengers.

While this is not specific to the Middle East, it is contrary to the trend that has developed in North America and Western Europe, where the prevailing notion is that passengers will not pay extra for increased service. Therefore, cost-cutting exercises have reduced passenger service levels to increase profitability. The traditional carriers in North America are emulating their low-cost carrier competitors to lower the cost of travel through a no-frills approach.

In the Middle East, the exact opposite is occurring. Traditional carriers are increasing service levels, and low-cost carriers are starting with higher service levels than their Western counterparts. Carriers such as Gulf Air have added chefs on board their premium service flights. The airline has added self-service kiosks, short messaging service and similar technologies to enhance the travel experience. And Gulf Air has improved lounges and check-in facilities throughout its stations and has re-branded itself to draw attention to its new, high-quality service standards.

Doha-based Qatar Airways has upgraded its fleet and facilities, Beirut-based Middle East Airlines has dramatically improved its product, and Dubai-based Emirates airline continues to provide a very high-quality product. Nearly every carrier in the region is updating its service to increase the value of its product.

Carriers risk a significant amount when they increase service levels. This risk is particularly great when they have renewed their fleets to increase service. Unit costs are rising among the carriers that are increasing their service, and it is yet to be determined whether these increased service levels will allow yields

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product

Agent Sales Report

description

The *Agent Sales Report* is a comprehensive reporting and reconciliation tool that tracks all agents' ticketing activity, improving the integrity of revenue recognition for that airline.

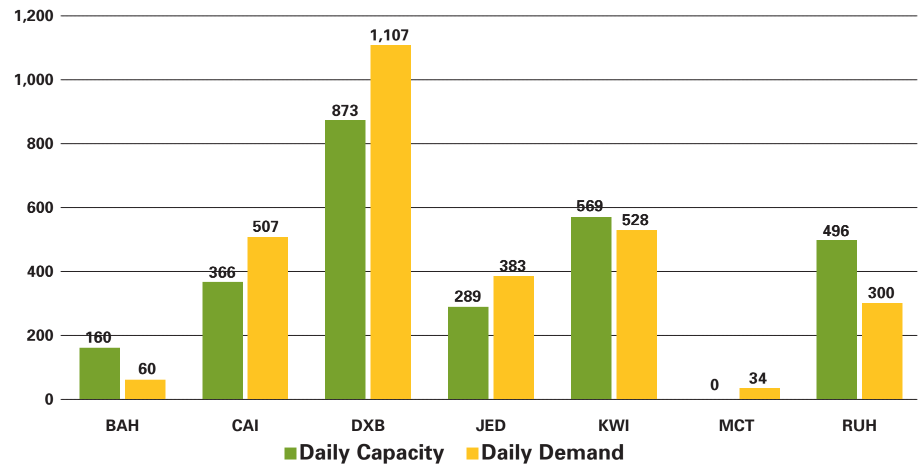
benefits

The *Agent Sales Report* provides an airline easy access to any ticketing transaction type stored in the database. Interactivity between reports and the introduction of a structured method of inputting manual document details into an agent's sales report ensures all agent ticketing activity is recognized.

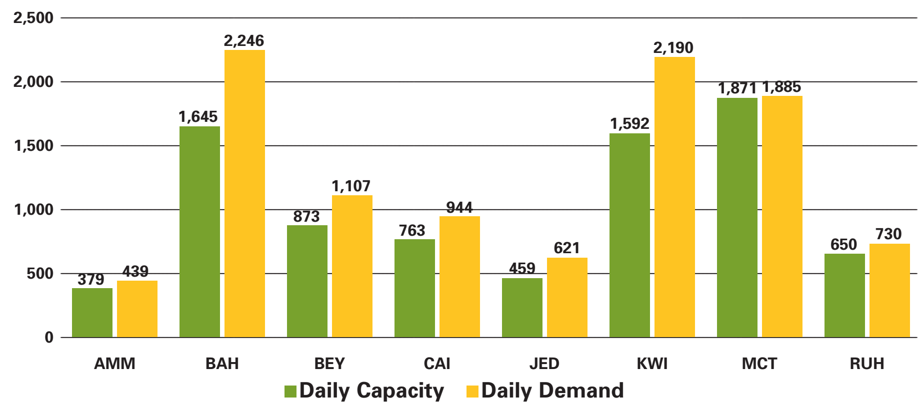
features

- **Enhanced analysis of ticketing activity** — Designed using a relational database, *Agent Sales Report* enables ticketing activity reports to be created dynamically. Once individual agent and station manager reports have been closed, a data feed is generated to an airline's revenue accounting system.
- **Comprehensive data** — The *Agent Sales Report* offers expanded ticketing activity including the ability to easily integrate manual document details into an agent's sales report and provides seven unique reports — sales summary, detailed report, accounting report, credit card report, tax report, station summary report and station manager report.
- **Increased productivity** — The *Agent Sales Report* enables an agent to void and reactivate voided items directly from the agent's sales report. Additionally, a supervisor can access view details on a particular item by selecting an item from the summary report.

Capacity and Demand to/from Beirut, January 2003 — December 2003



Capacity and Demand to/from Dubai, January 2003 — December 2003



The rapid rate of growth of Dubai as an origin and destination illustrates bilateral conditions are more often liable to restrict the growth of the aviation sector instead of protect the local carrier. Despite the rapid growth of capacity in and out of Dubai, many O&Ds from Dubai are substantially underserved.

to remain sufficiently high. If carriers are unable to attract high-value premium travelers, they can suffer substantial financial difficulties. In addition, the susceptibility of the region to demand volatility increases the level of risk associated with increasing service.

To reduce the impact of higher service costs, Middle Eastern airlines are flying their new aircraft more often, splitting fixed operating costs and indirect costs over a greater amount of flying, lowering unit costs, which should increase profits. Yet profits may not rise as unit costs fall if yields fall as well. While carriers try to increase yields by introducing higher service, it requires them to fly their aircraft more, placing more capacity in the marketplace — even during times of low demand — causing a capacity glut that reduces yields. Therefore, the very benefits that these carriers hope to achieve from increased service may indirectly force their profitability to remain low.

There is no easy answer to this dilemma. On one hand, carriers that do not increase service levels will lose market share among premium passengers. These carriers, however, will maintain a lower cost base, which could help them weather hard financial times. On the other hand, carriers that increase their service level will drive up unit costs that may not be covered by increased retention of premium demand.

The result is that the carriers in the Middle East are fighting for market share of the premium passengers even as the size of the market place increases. The region is growing, but the largest carriers in the region are forced to compete every day for the high-value premium passengers. Not all carriers can prosper in the Middle Eastern marketplace where share shift is the primary way of maintaining profitability, but this does not mean that carriers will fail and remove capacity.

Hope for the Future

The Middle East marketplace is a fascinating example of the brutal effects of aggressive competition. The carriers are fighting strength with strength in a marketplace that has unique challenges. Some of the carriers in the region will prosper while others will inevitably decline.

The Middle Eastern aviation marketplace is at a critical crossroads. A few years of geopolitical stability along with continued regional growth should allow for Darwinian evolution — survival of the fittest. If, however, events continue to reduce market demand, the investments in service improvement that have been made by the region's carriers may mean that all carriers have difficulty. The aviation marketplace in the Middle East must remain strong because there are few alternatives for travel throughout the region, a vast area that encompasses large tracts of desert and offers limited transportation infrastructure.

Solving the dilemma of Middle East aviation will not be simple, but there is hope in regional cooperation. Today, largely due to choice as well as cultural issues, no Middle Eastern airline participates in a global alliance. Airlines throughout the Middle East would do well, however, to cooperate among themselves through virtual alliances or vertical integration, both of which are trends for similar regional entities in other locations. The common cultural ties of Middle Eastern carriers should be a bonus to cooperation, not a hindrance. The Arab Air Carriers Organization plays a strong role in bringing Middle Eastern carriers together. More and more, the success of the aviation marketplace in the region will be based on the ability of the AACO to operate as a catalyst for bringing the disparate regional interests together in a manner that promotes the health of the region's air travel industry. a

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